MULTIMEDIA UNIVERSITY

STUDENT ID NO

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# MULTIMEDIA UNIVERSITY

# FINAL EXAMINATION

**TRIMESTER 2, 2016/2017**

## BAC4674 – INTEGRATED CASE STUDIES

( All sections / Groups )

27 FEBRUARY 2017
9.00 a.m – 12.00 p.m
( 3 Hours )

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**INSTRUCTIONS TO STUDENTS**

1. This question paper consists of 5 pages with 5 Questions only.
2. Attempt **ALL FIVE** questions. The distribution of the marks for each question is given.
3. Please print all your answer in the Answer Booklet provided.

## Giant Stores Corporation

Following the end of World War II, large discount stores began appearing in the major cities of the northeastern United States and then quickly spread across the nation. Numerous mergers among these stores led to the formation of large discount retail chains that could offer even greater discounts to their customers given the huge quantities in which they purchased goods. Discount chains flourished for more than two decades with their low overhead cost structures and deep discount pricing strategies. In the early 1970s, discount retailers began seeing their sales drop as many customers began opting for the higher product quality and better service available in major department stores.

Giant Stores Corporation was one of the discount retailers that began experiencing financial problems in the early 1970s. Founded in 1959 and headquartered in Chelmsford, Massachusetts, Giant Stores realized dramatic sales growth during the 1960s. By 1972, the company was operating one hundred and twelve retail outlets. In that year, Giant Store's executive faced the prospect of reporting a net loss for the first time in the company's history. But that loss was not reported. By manipulating the company's financial records, Giant Stores' executives converted a $2.5 million loss for 1972 into a $1.5 million profit. This dishonesty did not go unpunished. When the accounting chicanery was later revealed, a federal grand jury indicted several of the company's officers on various fraud charges. Four of those officers either pleaded guilty or were convicted of the charges.

### Accounts payable irregularities

A principal means Giant Stores executives used to misrepresent their company's financial condition was understating amounts owed to suppliers. Exhibit 1 summarizes the five major fraudulent schemes concocted by the executives to understate the company's year-end accounts payable for fiscal 1972, which ended January 29, 1972. Exhibit 1 also reports the dollar amounts involved in each of these schemes and the reasons given to Touché Ross, the company audit firm, for the accounting adjustments used to distort the balances of individual payable.

| Vendor | Reductions in accounts payable balances | Purported reason for reduction |
|---|---|---|
| Various | $300,000 | Previously unrecorded advertising credits |
| Millbrook Distributors | $257,000 | Return of merchandise, volume discounts, and a concession to retain Giant Stores as a customer |
| Rozefsky, Inc. | $130,000 | Return of merchandise |
| Various (referred to as overcharges by the SEC) | $177,000 | Overcharges on earlier invoices |
| Several health and beauty aid (HBA) manufacturers | $162,000 | Return of merchandise |

**Exhibit 1: Accounts payable balances intentionally understated by Giant Stores executives**

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**Advertising credits**

An investigation by the Securities and Exchange Commission (SEC) revealed that Giant Stores president and treasurer ordered the head of the company's advertising department to fabricate $300,000 of fictitious advertising credits near the end of fiscal 1972. The advertising manager complied by preparing a fourteen-page memorandum listing alleged advertising credits granted to Giant Stores by approximately eleven hundreds of its suppliers. (Note: Recognize that individual payable accounts were debited when these "credits" were recorded.) Touché Ross auditors were surprised by the number and cumulative dollar amount of the advertising credits. When the auditors questioned client officials, they were told that the advertising department had been negligent in recording and collecting the credits over the previous several months.

To test the fourteen-page listing of advertising credits, Touché Ross mailed confirmations to four of the vendors on the list and asked client personnel to provide supporting documentation for another twenty to the advertising credit. The SEC maintained that the audit procedures applied to the advertising credits were inadequate for several reasons. First, according to the SEC, the sample size of twenty-four items did not provide sufficient evidence to reach a valid conclusion regarding the material accuracy of the cumulative $300,000 of the advertising credits. Second, Touché Ross apparently failed to follow up on comments made by vendors who returned the accounts payable confirmations. Many of these comments suggested that the purported credits were in error. Third, the SEC criticized Touché Ross for relying on internal client documentation to corroborate the secondary sample of twenty credits selected for testing. Given the suspicious nature and timing of the advertising credits, the sec maintained that Touché Ross should have obtained more rigorous and extensive audit evidence to support those twenty items.

**Millbrook Distributors**

Giant Stores chairman of the board and the company's vice president of finance produced twenty-eight fictitious credit memos in early 1972. These credit memos reduced by $257000 the outstanding balance of Giant Stores payable to Millbrook distributors, a major supplier of health and beauty aids. Touché Ross auditors were given three different explanations regarding the source of these credit memos. Initially, the auditors were told that the credit memos were for merchandise returns. Then they were told that the credit memos resulted from volume discounts granted to Giant Stores. Finally, client management reported that the reduction in the Millbrook payable was a concession Millbrook made to retain Giant Stores as a customer. A Touché Ross staff auditor questioned the credibility of the latter explanation. The payable reduction seemed much too large a price for Millbrook to pay to retain Giant Stores as a customer, given the relatively modest volume of the transactions between the two companies.

Touché Ross eventually requested that a Millbrook executive confirms the $257,000 concession grated to Giant Stores. In response to this request, Giant Stores vice president of finance placed a telephone call, in the presence of Touché Ross auditors, to an individual who was supposedly Millbrook president. Following a brief conversation, the vice president handed the phone to a Touché Ross auditor. The individual on the other end of the line verbally confirmed the concession and agreed to send Touché Ross written confirmation to that effect. A few days later, Giant Stores vice president of finance informed Touché Ross that Millbrook president had changed his mind about providing the written confirmation.

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Millbrook's president was reportedly angry because the confirmation had not been delivered to him personally, as he had requested. At this point, the two staff auditors questioned the validity of the $257,000 reduction in the Millbrook payable. Despite this memo, the audit engagement partner decided that sufficient evidence had been collected to support the reduced balance of the Millbrook payable and chose not to pursue the matter any further.

**Rozefsky, Inc.**

Another vendor of Giant Stores in the early 1970s was Rozefsky, inc. Giant Stores personnel reduced the amount owed to this vendor at the end of fiscal 1972 by $130,000. This understatement was accomplishedly posting (debiting) thirty-five false credit memos to Rozefsky's payable account. These credit memos were allegedly issued for goods returned to Rozefsky by various retail outlets of Giant Stores. The SEC subsequent investigation revealed that many of these memos were issued to stores that did not even stock Rozefsky product. Additionally, the SEC discovered that Rozefsky's financial records did not contain references to, or entries for, any of the thirty-five credit memos allegedly issued to Giant Stores.

When a Touché Ross staff auditor was given copies of the Rozefsky credit memos, he noticed that a felt tip marker had been used to obscure a typed sentence on each of them. By holding the memos up to a light, he was able to read the obscured sentence: "do not post until merchandise is received." Ostensibly, this not informed a Giant Stores accounting clerk not to reduce the rozefky account balance for the invoiced goods until the cost of the goods was credited to that account.

After reviewing the credit memos, the Touché Ross staff auditor called a Rozefsky accountant and inquired regarding that alleged merchandise returns. The accountant reported that none of the goods had been returned by Giant Stores. The staff auditor informed the Touché Ross audit engagement partner of the memos and his conversation with the vendor's accountant. When told of this matter by the audit partner, Giant Stores vice president of finance responded that he spoke with the Rozefsky accountant shortly after the staff auditor contacted that individual. According to the vice president of finance, the Rozefsky accountant indicated that the staff auditor had misinterpreted their conversation regarding the memos. Additionally, the Rozefsky accountant reportedly confirmed to the vice president that the memos actually were for returned goods. The vice –president insisted that the audit partner not contact the Rozefsky accountant to discuss the matter any further because of pending litigation between the two companies. The audit partner ultimately accepted the client's explanation for the credit memos after receiving letters confirming the merchandise returns. These confirmation letters were provided were provided by the managers of the Giant Stores who allegedly ordered and then returned the merchandise in question to Rozefsky.

**Accounts Payable Overcharges**

Giant Stores executives instructed two subordinates to prepare a list of several hundred merchandise purchases on which Giant Stores had been supposedly overcharged by suppliers. These overcharges totaled approximately $177,000. Touché Ross audited these overcharges by selecting random line items from the client-prepared list and then confirming the overcharges via telephone calls to the vendors.

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The procedure used in soliciting the fifteen telephone confirmations allowed giant to communicate with the vendor first and inform the vendor that Touché Ross would be calling them. Giant placed a second call to re-explain the nature of Touché Ross inquiry, after which the telephone was handed to the Touché Ross auditor. Only then was the Touché Ross auditor permitted to speak over the telephone to the vendor. The result of this confirmation procedure and limited other audit test persuaded Touché Ross to accept the overcharges as valid reductions to the various payable accounts. The subsequent SEC investigation disclosed that, under similar circumstances, three of Giant Stores suppliers provided false confirmations to Touché Ross after apparently being convinced to do so by Giant Stores executives. Quite possibly, the confirmations for the overcharges were victimized by the same deception.

**HBA credits**

A final deliberate understatement of accounts payable involved several large credit memos that Giant Stores had allegedly received from health and beauty aid (HBA) manufacturers. The credit memos indicated that Giant Stores had returned $162,000 of merchandise to these manufacturers. Apparently none of these merchandise returns ever occurred. Similar to the other fictitious entries to Giant Stores accounts payable, the SEC criticized Touché Ross for failing to adequately investigate these items.

**Additional SEC criticism of the 1972 Touché Ross audit of Giant Stores**

Besides criticizing the audit procedures applied to accounts payable, the SEC raised concerns regarding several other facets of Touché Ross 1972 audit of the Giant Stores. Of particular concern to the SEC was the extent of pressure that Touché Ross allowed Giant Stores executive to impose on members of the audit engagement team: "The audit was conducted under stressful conditions including a request from giant to Touché Ross to fire (the audit engagement partner), a Giant executive's threat to throw one staff auditor off the premises and verbal abuse of a staff auditor from another Giant executive." At one point during the audit, the bullying tactics of Giant Stores' executives and the suspicious nature of the large year-end adjustments to accounts payable led one staff auditor to suggest that the client was engaging in, and attempting to cover up, an accounting fraud. Unfortunately, the audit engagement partner chose to ignore the staff auditor's speculation.

The SEC also charged that the Touché Ross audit engagement partner and a second partner who assisted in completing the audit were overly willing to compromise with client personnel. According to the SEC, certain audit judgments were arrived at through a trade-off and bargaining process was particularly evident during a meeting between the two Touché Ross audit partners and Giant Stores executives. This meeting took place in April 1972, shortly before the completion of the 1972 audit. The purpose of the meeting was to determine the final disposition of several questionable items that the Touché Ross auditors identified during the course of the audit.

During this meeting, giant personnel continuously calculated earnings per share on a pocket calculator. When the calculations reached giants reduced target earnings of $0.83 per share, giant ceased to be contentious.

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## Collapse of Giant Stores

Giant Stores filed its 10-K statement for the fiscal year ended January 29, 1972, with the SEC on April 28, 1972. The 10-K included an unqualified audit opinion issued by Touché Ross on Giant Stores financial statements. Those same financial statements and the accompanying audit opinion were used later in the year by Giant Stores to help sell $3 million of additional stock and to raise $12 million of debt capital. In an April 1973 press release, the president of Giant Stores disclosed that "bookkeeping errors" had been discovered that might affect the company's reported profit for the prior year. Approximately one month later, Touché Ross withdrew the unqualified opinion it had issued on Giant Stores 1972 financial statements. In august 1973, Giant Stores filed a bankruptcy petition with a federal court in Boston. Two years later, that court declared the company insolvent and liquidation proceedings were begun.

The former president and vice president of finance of Giant Stores were convicted in 1978 of conspiracy to file false financial statements with the SEC. prior to those convictions, the former chairman and treasurer of Giant Stores pleaded guilty to the similar charges. Each of the four individuals was fined and given jail terms ranging from six to eighteen months. The SEC issued the final report on its lengthy investigation of the Giant Stores fraud in June 1979. As a result of that investigation, the SEC censured Touché Ross and prohibited the Giant Stores audit engagement partner from practicing before the federal agency for five months. The SEC also required Touché Ross that the SEC instructed the independent panel to review.

### Questions

1. List and explain five management assertions identified in SAS No. 31, "Evidential Matter," in auditing accounts payable. In your opinion which is of primary concern to the auditor? Why?

   (25 marks)

2. The search for unrecorded liabilities is a common substantive test used at year end to obtain evidence regarding the material accuracy of a client's current liabilities. Briefly explain the nature (procedures) of the search for unrecorded liabilities. How might this audit procedure have resulted in the detection of the irregularities in Giant Stores account payable?

   (20 marks)

3. Discuss the validity of the audit evidence collected via telephone confirmations. Under what general conditions is it permissible for auditors to accept telephone confirmations?

   (20 marks)

4. How do accounts payable and accounts receivable confirmation procedures differ? Comment on both technical differences and differences in audit objectives between the two audit tests.

   (20 marks)

5. Identify and clearly explain who is the main protagonist is in the above case.

   (15 marks)

**(Total: 100 marks)**

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